

16 June 2020



Andy Doube
Electricity Authority
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By email: HME.feedback@ea.govt.nz

Dear Andy and Tom

Re: Consultation paper – Hedge Market Enhancements

Flick appreciates the opportunity to submit on the Electricity Authority's (Authority's) options for market making arrangements on the ASX exchange traded futures platform to assist the Authority's decision on the approach to enduring market making services.

However, as discussed previously, we reiterate our position that resolving market making is tinkering around the edges and will not solve the fundamental issues with the wholesale market that mean the retail businesses of incumbent gentailers (market makers) are protected by internal arrangements with their generation activities from prices faced by independent retailers on the spot and hedge market. As long as the current arrangements persist the playing field for electricity retailers will be tilted in favour of vertically integrated retailers and against independent retailers. This contradicts the expectations of the Minister of Energy and Resources that "changes include requiring big power companies to sell electricity at affordable rates into the wholesale market to level the playing field for smaller and independent retailers".¹

Flick submits the Authority should be urgently progressing work on analysing and publishing the level of, and rationale for, the prices of gentailers' internal contracts and separate financial reporting by gentailers². In our view, this is the highest priority project as the outcome of this work will have significant long-term benefits for consumers.

Our views on wholesale market reform are also relevant to this consultation paper as our suggested solutions will improve confidence in the ASX market to deliver fair prices and a transparent robust forward price curve.

We have also provided feedback on the trade-offs / assessment / decision making criteria as well as how the proposed criteria have been applied against

¹ See Minister's media release "Government levels electricity playing field for consumers" 3 October 2019
<https://www.beehive.govt.nz/release/government-levels-electricity-playing-field-consumers>

² Electricity Price Review Panel recommendation D3 <https://www.mbie.govt.nz/assets/electricity-price-review-final-report.pdf>

the six options to support finalising an enduring solution for market making as soon as possible. Flick supports and continues to believe that mandating market making is the only efficient solution.

This submission is in addition to the joint independent retailers' submission from ourselves, Ecotricity, Electric Kiwi, energyclubnz, Pulse and Vocus.

Wholesale market reform

Our focus continues to be on ensuring a level playing field for independent retailers. Mandating market making will increase the reliability of, and confidence in market making services and should promote competition. But it will not alter the incentives on vertically integrated incumbents (and market makers) to discriminate in favour of their own retail businesses by, for example, limiting hedge products to external retailers, offering low related party transaction prices from their wholesale operation to their retail etc.

Our joint submission discusses and disagrees with the Authority's presumption that vertical integration is inherent and unquestionable in the NZ electricity market. It is clear the advantages of vertical integration are benefiting the vertically integrated incumbents at the expense of thriving retail competition.

Gentailers have contracts, usually fixed price variable volume and any shape contracts, between their generation and retail businesses. Gentailers' retail businesses are therefore not financially exposed to prices on the spot or hedge markets.

We recommend all retailers must be required to purchase electricity through the same markets as independent retailers. Independent retailers, by definition, already buy all their electricity from the spot and hedge markets and are always net buyers as well as being price takers. Our solution requires gentailers' retail operations to purchase from, and be exposed to, the spot and hedge market prices (and not be protected from prices on these markets by contracts with its generation business). This would ensure wholesale market arrangements offered independent and other retailers a level-playing field (same wholesale input cost) on which to compete.³

Flick urges the Authority to prioritise work on revealing / analysing / publishing the level of, and rationale for, the prices of gentailers' internal contracts. In addition, the Authority must undertake 'Equivalence of Input' testing to determine whether market makers are using vertical integration to impose price barriers, as recommended in our joint submission. In our view, both these pieces of work will provide further evidence that our proposed solution is a necessary regulatory intervention.

³ We refer you to previous submissions with more information about our recommended solution: 2 December 2019: <https://www.ea.govt.nz/dmsdocument/26514-ecotricity-electric-kiwi-energyclubnz-flick-electric-pulse-and-vocus-hedge-market-enhancements-submission>

Market making option

Flick suggests the Authority's proposal of six possible options for market making arrangements is adding unnecessary complexity, confusion and potentially delaying any decisions. In our view, there are only three options that warrant consideration: voluntary with a mandatory backstop which is the status quo and counterfactual; commercial; and mandatory; for the following reasons:

Option		Reason
1	Voluntary approach	This has already been tried and the Authority decided it was not delivering long term benefits for consumers when it introduced backstop mandatory market making Code on 3 February 2020 DELETE THIS OPTION
2	Voluntary approach with a mandatory backstop	This is the status quo. Any other options should be compared relative to this benchmark (including the fact that Code already exists)
3	Commercial approach	We presume the incentivised market making scheme being developed by the ASX working group of current market makers (and blind to most participants) is the commercial approach. This is very similar to the current 'voluntary' arrangement- we are not aware of anything prohibiting the ASX from signing up a market maker that is not involved in the NZ electricity market? The principal difference is that the Authority would design the market making arrangements, be the person contracting for market making services and therefore able to recover the costs
4	Mandatory-commercial approach	The fact that the threat of mandating market making for non-performance does not apply to commercial non-industry participants makes this approach non-sensical DELETE THIS OPTION
5	Mandatory approach with transferable providers	Any market maker can sub-contract its obligations under any of these arrangements without having particular regulatory intervention ⁴ DELETE THIS OPTION
6	Mandatory approach	The Code is already written for this option and in place as a backstop

As a result, the Authority should be assessing the pure commercial and pure mandatory approaches against the current arrangements which are voluntary (commercial) with a mandatory backstop.

⁴ The only regulatory restriction should be that 2 mandated market makers cannot contract with the same third party – that is, it has to be a one-to-one relationship between a market maker and the commercial provider they sub-contract to.

As you know, Flick, along with our group of independent retailers, strongly supports mandating market making.

Trade-offs

In this section we discuss the nature of the five key trade-offs.

The five trade-offs listed in paragraph 5.3 are features of any market making arrangement – which to a greater or lesser degree are positive or negative for each of the Authority’s proposed market making approaches.

The more important decision criteria are whether the market making option increases confidence in and the reliability of market making (paragraphs 5.5 – 5.6) and satisfies the Authority’s statutory objective.

We are concerned that the analysis relating to satisfying the statutory objective focuses on promoting efficiency (paragraph 5.9):

“At this point the Authority considers efficiency is the most relevant element to making distinctions between the various approaches. This is because the different approaches vary in their ability for the Authority to incorporate markets during the detailed design and implementation phase – which should lead to a more efficient outcome, and ultimately more benefit for consumers.”

There is already a key trade-off called “possible to involve markets in the design of market making services”. This key trade-off only contributes to ‘promoting efficiency’.

Why does the Authority propose to have it both ways? Or does one cancel out the other? The current approach appears to be a tautology.

Looking at the key trade-offs against the key decision or success criteria reveals:

Key decision / success criteria:	Increases reliability	Increases confidence	Promotes efficiency (stat obj)
Key trade-offs:			
1. Possible to adjust the number of market makers	√	√	
2. Possible to increase the diversity of market makers	√	√	√
3. Possible to involve markets in the design of market making services			√
4. Possible to allocate the costs of market making	√		√
5. What are the consequences of non-performance	√	√	

Is it appropriate that the Authority's analysis results in:

- two key trade-offs not contributing to achieving the Authority's statutory objective (1. possible to adjust the number of market makers and 5. what are the consequences of non-performance)?
- one key trade-off achieving only one of the 3 key measures of success (3. possible to involve markets in the design of market making services)?

In addition, Flick strongly recommends the decision-making criteria relating to satisfying the statutory objective is 'promoting competition' (and not promoting efficiency). This would encompass ensuring:

- competition in market making services;
- retail competition; and
- competition in generation offers into the hedge market.

Comments about each of the five key trade-offs

1. Possible to adjust the number of market makers

Flick suggests the Code can be written in a way that enables a change/increase in the number of market makers at any time by including criteria that, if met, means an organisation would become a market maker.

2. Possible to increase the diversity of market makers

Flick agrees diversity of market makers could be positive. However, the practicality of implementing this is questionable. Asymmetry of information will be a key concern to commercial market makers and this risk could be priced into the offer of market making services – increasing the price paid to all parties providing market making including current market makers. We query whether there would be a truly competitive process of 'tendering' to provide market making when creating a diverse set of market makers. Existing market makers may not value having external parties involved in market making because, for example, a market making expert may be prepared to trade at lower spreads or of risks involved with having less informed parties involved.

3. Possible to involve markets in the design of market making services

As discussed above, this trade off should be deleted. We disagree with how the Authority expects market making to contribute to achieving the statutory objective (promoting efficiency) and this is the only trade-off that contributed to that.

The Authority should seek advice from an expert in market making to assist with the design of market making services, including a mandatory scheme. This advice should be able to address what is an efficient level of service for a market of New Zealand's size and complexity, the risks / costs of provision / consequences of non-compliance dilemmas in an impartial manner.

4. Possible to allocate the costs of market making

As discussed in the joint submission, we disagree with the Authority’s underlying assumption that beneficiaries should pay for market making.

Further, we strongly recommend the Authority collects robust information about the current costs of providing market making to have an accurate counterfactual, as well as why the costs would be any different if the backstop Code was in place. The Authority should understand how these costs are derived; for example, is it the cost of a staff member performing the trading? is it the opportunity cost of not being able to buy/sell the volumes offered in market making to other customers? is it the cost of being caught on the wrong side of a transaction?

5. What are the consequences of non-performance

We agree the voluntary approach has weak financial penalties for non-performance which has been proven and addressed by the current arrangements (commercial + mandatory backstop).

Assessment of approaches against key trade-offs

The following comments relate to Table 1 in the consultation paper.

Approach	Key trade-offs	Comments
Voluntary with mandatory backstop	Can involve markets in design	EA rating: X Weak
	We disagree with the Authority’s rating. Advice from an expert in market making could address the likely risk / cost trade-off.	
Commercial	Can adjust number of market makers and	EA rating: - Neutral; Authority can attract more market makers by increasing payments
	Can increase diversity of market makers	EA rating: √ √ Very strong; Authority can contract non-physical market makers by increasing payments
	We query why the rating for these two trade-offs is so different when the comments are effectively the same. We also disagree that the Authority has the discretion to increase payments – the level of payments should only be determined by a competitive tender process. Existing market makers may be prepared to offer the service at a cost less than non-industry participants.	
Mandatory with transferable providers	Can involve markets in design	EA rating: √ Strong; Authority may gather price/quality trade-off data from obligated parties
Mandatory		EA rating: X X Very Weak; Authority administratively determines service levels with no market data
We disagree with the assumption that the Authority will have access to price / quality data from a commercially confidential contract between the mandated party and a third-party provider. The Authority should seek advice from an independent expert about service levels / risk / cost so that involving markets in design is positive for developing mandatory market making.		

In summary

Flick continues to strongly supports mandating market making. In relation to the consultation paper Flick submits:

- only three possible approaches to market making should be under consideration: voluntary with mandatory backstop (status quo), commercial, and mandatory
- the five trade-offs should not be used to determine which market making approach to develop
- the key decision / success criteria should be
 - increases reliability of market making services;
 - increases confidence in market making services; and
 - promotes competition to satisfy the statutory objective.

We query the Authority's next steps – will the Authority consult on a revised list of market making approaches using revised decision-making criteria based on submissions received?

However, as discussed above, resolving an enduring market making arrangement is only tinkering around the edges. A resolution to wholesale market pricing that results in a level playing field for retailers where independent retailers and vertically integrated retailers face the same wholesale input costs will enable increased retail competition based on innovation and choice with significant long-term benefit for consumers. The Authority has acknowledged that "Less competition means less choice for consumers and potentially higher electricity bills"⁵. When all retailers are required to purchase electricity from the spot and hedge markets (and not from non-transparent internal agreements), the significantly increased volumes (from ~14% net generation to 100% of all generation) will have the additional benefit of contributing to confidence in the ASX market that prices are the right prices. Generators will be competing for customers for their entire generation (instead of maximising profits from their net generation volumes). Flick strongly urges the Authority to prioritise work revealing the level of, and rationale for, the prices of gentailers' internal contracts and creating a level playing field for all retailers.

We welcome the opportunity to discuss this submission with you in more detail.

Yours



Steve O'Connor
Chief Executive

⁵ <https://www.ea.govt.nz/about-us/media-and-publications/covid-19/authority-update/httpswww-ea-govt-nzabout-usmedia-and-publicationscovid-19authority-updatemay-2020/>